2005 BCSECCOM 522

Connor Financial Corporation and Joel Gerrett Connor

Section 165 of the *Securities Act*, RSBC 1996, c. 418

Hearing

Panel	Douglas M. Hyndman	Chair
	John K. Graf	Commissioner
	Roy Wares	Commissioner

Dates of Hearing August 9 and 10, 2004

Date of Decision August 10, 2005

Appearing

C. Paige Leggat For commission staff

Joel Gerrett Connor For himself

Decision

Introduction

¶ 1 This is a review under section 165(3) of the *Securities Act*, RSBC 1996, c. 418. Joel Gerrett Connor and Connor Financial Corporation seek to overturn a decision by the commission's director of capital markets regulation. Commission staff oppose the application.

¶ 2 The parties agreed that the review would proceed as a new hearing, in which commission staff had to make the case for the director's decision to stand.

Background

Parties

¶ 3 Connor Financial Corporation (CFC) has been registered under the Act as a mutual fund dealer since 1984. It carries on the business of a mutual fund dealer in Victoria. Joel Gerrett Connor is the only shareholder of CFC. He is also registered as the trading partner of CFC and is its designated compliance officer. CFC had two other registered salespersons in 2001 but it appears that Connor is currently the only registered individual with the firm.

¶ 4 Connor also owns Connor Financial Services International (CFSI), which is not registered under the Act. Until the decision under review, CFSI made loans to

clients of CFC to finance mutual fund investments. Some of the loans are still outstanding. CFSI financed the loans by borrowing from CFC. Connor was the lending officer of CFSI until December 2003.

History

¶ 5 CFC and Connor have had several previous run-ins with commission staff. Several times Connor has been cited for misleading advertising. The most significant dispute involved an arrangement under which CFC illegally retained interest earned on client funds and, on more than one occasion during the resolution of this issue, used underhanded methods in an attempt to avoid complying with regulatory conditions imposed on him. Following court proceedings and commission hearings from 1994 to 1996, CFC was ordered to repay to clients and contribute to the dealer contingency fund some $280,000 in illegally retained interest and to pay fines of $40,000 and $10,000 to the commission.

¶ 6 CFC and Connor still appear to have a testy relationship with commission staff but nothing very serious has arisen since the 1996 proceedings.

¶ 7 In March 1999, commission staff, following a routine compliance examination, objected to CFC's practice of lending money to clients and to its recording the loans as assets in its working capital calculation. Staff took the position that lending to clients was beyond the proper scope of a mutual fund dealer's business and that it was contrary to the interests of clients.

¶ 8 In August 1999, after several exchanges of correspondence, staff agreed to permit CFC to lend to clients if CFC made the loans through a separate corporate entity and complied with some other conditions. This decision was set out in a letter from Ross McLennan, then director of Registration. One of the conditions was that mutual fund units held by clients of CFC be registered in the clients' names, not in CFC's name. Staff also agreed to allow CFC to finance the loans through the separate entity and to record the receivable from the separate entity as a current asset in CFC's working capital, provided "the additional securities" were pledged to CFC. (The reference to "the additional securities" is not clear and subsequent correspondence showed that the parties did not have a common understanding of what that condition meant.)

¶ 9 Connor then incorporated CFSI to conduct the lending activities. CFC transferred its loan portfolio to CFSI, in exchange for a demand loan. At that time, CFC had loans outstanding of about $960,000 to 96 clients. Interest rates on the loans vary. Most of those in evidence were at 12% per year. Some were at lower rates and some were at bank prime plus 3%.

¶ 10 In October 2000, staff re-opened the lending issue. They conducted a follow-up compliance examination and a separate review of the lending activities. In a January 2001 letter to CFC, staff set out the deficiencies found in the examination, of which two are relevant here.

¶ 11 First, staff said that CFC had not complied with the condition that mutual fund units be registered in the client's name only and asked CFC to set out a time frame for complying. CFC responded in March 2001 that it did not plan to follow that direction. Staff are not pursuing this issue in this proceeding.

¶ 12 Second, staff said that CFC had not met the condition for its receivable from CFSI to be accepted as a current asset, which was that "the additional securities" be pledged to CFC. CFC responded by sending a copy of an agreement in which CFSI had pledged its loan receivables against the amount it owed to CFC. Staff seem to have dropped this point too.

¶ 13 As part of the October 2000 examination, staff reviewed the files for seven clients that had loans from CFSI to determine whether the suitability of investments was compromised by the loans. The review was inconclusive.

¶ 14 Nevertheless, staff subsequently concluded that the CFSI arrangement did not satisfactorily resolve the concerns about lending to clients. In October 2001, Gerry Halischuk, who had replaced McLennan as director of the renamed Capital Markets Regulation division, gave CFC and Connor notice and an opportunity to be heard about two things he proposed to do. He proposed to impose conditions on their registrations that would prohibit further lending activities and he proposed to withdraw the previous variation that McLennan had granted to let CFC treat the receivable from CFSI as a current asset in its working capital calculation.

¶ 15 Counsel for CFC and Connor made submissions in some correspondence with staff. Then, on January 18, 2002, Halischuk sent a letter to counsel for CFC and Connor saying that he had decided to impose the conditions and withdraw the waiver. That is the decision CFC and Connor seek to overturn.

¶ 16 While this was going on, the commission worked with other regulators and the mutual fund industry to create the Mutual Fund Dealers Association, a new self-regulatory organization, to act as the front line regulator for mutual fund dealers. In March 2001, the commission amended section 6 of the Securities Rules, B.C. Reg. 194/97, to require mutual fund dealers to become members of the MFDA.

¶ 17 MFDA rule 3.2.1, adopted in February 2001, prohibits a mutual fund dealer from lending to its clients. In August 2003, the MFDA amended rule 3.2.1 to prohibit an approved person from lending to clients of the dealer. (Connor would be an

approved person if CFC were an MFDA member.) As of May 18, 2004, the MFDA has never exempted any member or approved person from the requirements of rule 3.2.1.

¶ 18 Staff asked the MFDA about whether rule 3.2.1 would prohibit lending to clients through a separate company with the same ownership as a member firm. The MFDA said it would be concerned about a member doing indirectly what it would be prohibited from doing directly, but it emphasized that it was commenting on a hypothetical basis and that applying its rule "to any particular situation requires assessment of all of the relevant facts and considerations and it is difficult to comment generally on whether lending in any such circumstances would be inappropriate."

¶ 19 Pending the hearing and review and this decision, CFC and Connor have undertaken to maintain sufficient working capital for CFC without including the receivable from CFSI and not to make any new loans or further advances to clients. They proposed to leave the existing loans in place and accept repayments in the normal course. Staff appear to have accepted this arrangement. Also, staff have granted CFC an extension on the requirement that it be a member of the MFDA. It now has until 60 days after this decision to join the MFDA.

The Loans

¶ 20 According to CFC's correspondence with staff, most of the loans to clients were short-term loans to finance RRSP contributions. Some clients borrowed to pay off and consolidate credit card debts at higher interest rates. At least one borrowed to finance construction of a new home in advance of selling an existing home.

¶ 21 In June 2001, CFSI's loans to clients totalled around $850,000. The amount outstanding fluctuated seasonally, generally peaking at the end of RRSP season and then declining as clients paid down their loans.

¶ 22 CFSI held a promissory note for each loan. The typical note was payable by the client on demand, but also specified an agreed repayment schedule. The client could repay the loan at any time without penalty. The note was secured by the client's investment funds held at CFC.

¶ 23 In 2003, CFC wrote to Lang Evans, who had replaced Halischuk as director of Capital Markets Regulation, seeking exemptions from the restriction on new loans to permit CFSI to make loans to three clients. One was to finance an RRSP contribution. The other two were to allow clients to consolidate debts without having to redeem investments held in RRSPs and incur the resulting tax costs. Staff declined to approve the requests.

¶ 24 Connor and CFC also presented as evidence a letter dated July 7, 2004, about a month before the hearing, from a client who complained that he had incurred higher costs borrowing from a bank than he would have incurred if CFSI had been permitted to lend him more money under an existing line of credit.

Analysis

¶ 25 Our task is to determine whether to confirm, vary, or revoke the January 18, 2002, decision of Gerry Halischuk, then director of Capital Markets Regulation. The director imposed, under section 36 of the Act, conditions on the registration of CFC prohibiting it from making loans to any person and on the registration of Connor prohibiting him from making loans directly or indirectly to clients of CFC. He also withdrew the waiver that McLennan had granted, under section 17 of the Rules, to let CFC include in its working capital calculation amounts owed to CFC by CFSI.

Arguments - staff

¶ 26 Staff argue that there is an "unambiguous and explicit legislative policy" to prohibit mutual fund dealers from lending to clients and that Connor and CFC should be prohibited from lending to CFC's clients, directly or indirectly. This argument is based on commission rule 6(2)(c)(ii)(A), which requires a mutual fund dealer to be a member of the MFDA, and MFDA rule 3.2.1, which prohibits a member or approved person from lending or extending credit to a client.

¶ 27 Staff describe the conflict of interest as follows: "When Mr. Connor grants a loan, he does so knowing that CFSI, the company of which he is sole shareholder, will make a profit, which goes directly into his pocket. As well, when he grants a loan to a person who then is able to purchase mutual fund securities from him through CFC, he knows that he will profit twice, once from CFSI's interest income and once from the fees he will obtain from CFC. … Because Mr. Connor profits so directly on all sides of the transaction, on the mutual fund business side and on the lending side, the temptation is very strong to promote leveraging to a level that is not in the client's best interest."

¶ 28 Staff say CFC's situation is different from that of a mutual fund dealer affiliated with a financial institution that lends money to clients of the dealer, because financial institutions are large hierarchical structures and are subject to their own regulatory regime.

¶ 29 Staff say the distinction between CFC and CFSI is artificial. Connor is the sole shareholder of both CFC and CFSI. He is CFC's trading partner, compliance officer and principal sales person. CFSI lends money to CFC's clients. CFSI borrows the money it lends to CFC's clients from CFC. Because he controls both of the companies and due to his multiple roles in the companies, staff say, there is

ample potential for conflict of interest. Staff say the conflict has been realized because clients who borrow from CFSI must sign a promissory note that prevents them from moving their investments from CFC.

¶ 30 Finally, staff say that, although the commission could exempt CFC from the restriction on lending to clients, we should refuse to do so for two reasons. First, staff suggest that the commission should not undercut the MFDA's process but leave Connor and CFC to seek any exemption from the MFDA. Second, staff suggest that Connor's and CFC's past regulatory history shows that it would be prejudicial to grant the exemption.

¶ 31 In support of the second part of the decision, staff argue that CFC should not be permitted to include CFSI receivables in its working capital calculation because those receivables are not generated in the normal course of CFC's business as a mutual fund dealer. Staff say that allowing CFC to include loans as a current asset masked ongoing capital deficiencies because, without including the receivable from CFSI, CFC did not meet the minimum working capital requirements.

¶ 32 Staff seek an order confirming Halischuk's decision and prohibiting CFC from lending money to its clients, directly or indirectly. Staff also seek a direction to oversee an orderly wind up of the existing lending business.

Arguments – Connor and CFC

¶ 33 Connor and CFC respond to these arguments by pointing out that they set up the structure to make the loans through CFSI at McLennan's request. They complain that staff have merely changed their position and argue that staff are unjustified in attempting to extend the prohibition on lending to cover CFSI, because it is a separate company and is not a registrant.

¶ 34 However, Connor and CFC go on to state the issue in a way that acknowledges staff's position that the distinction between CFC and CFSI is artificial: "Stripped of the historical and procedural baggage, the real issue to be addressed here is simply the practice of a mutual fund dealer, or in this case a company owned by a mutual fund registrant, lending money to the clients of the dealer. With respect to this specific issue, it seems that staff's material disclosed two primary concerns. Such transactions gives rise to a conflict of interest with the dealer, and the lending practices create a capital deficiency with the result that CFC's clients are not adequately protected."

¶ 35 Connor and CFC say the amount of the loans, about $700,000 in comparison with CFC's $80 million in client assets under management, show that the lending is a very modest activity. They note that (until stopped by staff) CFSI provided short term loans to enable clients to make RRSP contributions or consolidate credit card

debts, that clients were free to borrow elsewhere but often preferred the flexibility of the arrangements offered by CFSI, and that CFSI provided some very modest competition to financial institutions.

¶ 36 Connor and CFC suggest that financial institutions that lend to clients of affiliated dealers, and the lending employees of those institutions, are highly motivated to encourage clients to borrow and, if anything, have a greater conflict of interest than does CFC. They also argue that the regulation of financial institutions, which staff say justifies the different treatment of financial institution loans to clients of the institutions' affiliated dealers, is focused on protecting the interests of the institutions' depositors, not the clients of the affiliated dealers.

¶ 37 Connor and CFC say it is significant that, despite years of reviews, staff have never identified any examples of conflicts of interest adversely affecting clients. They say, "The only conflict of interest presented here today is a specious one that the taking of security by CFSI, or the securing of security for the loans, somehow constituted a conflict of interest."

¶ 38 Connor and CFC argue that CFC should be able to include the receivable from CFSI in its working capital calculation because the funds used to make the loans were originally generated from CFC's business. As they put it, "the fact that the capital was being used to lend to clients didn't change the fact that it came from the normal course of [CFC]'s business." They also argue that, in any event, the loans *were* in the normal course of CFC's business.

¶ 39 Connor and CFC point to "a certain irony" in staff's position that recording of the loan receivable as a current asset "masked ongoing capital deficiencies." Staff had been taking the position that CFC should register mutual fund securities in client name. Connor and CFC say that registering securities in CFC's name as a nominee for a client provides CFC with better security for the loans and that the capital risk staff worry about "would only arise if CFC complied with staff's ostensible requirement that it reregister all clients' assets in the name of the client." As it is, CFC says that CFSI has demand loans, made on a conservative basis and adequately secured, which should be recorded as current assets in accordance with generally accepted accounting principles.

¶ 40 Finally, Connor and CFC argue that, in saying MFDA rule 3.2.1 would prohibit CFSI from lending to CFC's clients, staff are speculating on how the MFDA would apply the rule. They note that the MFDA has refused to give CFC an answer on how the rule would apply until these proceedings are resolved and CFC makes an application for membership. They also point out that the interpretation the MFDA provided to staff was hedged with the statement that the MFDA could not comment on how the rule would apply in a particular situation. Connor and

CFC ask that we set aside staff's decision and let CFC get on with an application to the MFDA to test the interpretation of rule 3.2.1.

Analysis

¶ 41 CFC is registered as a mutual fund dealer and, if not for the exemption staff have given it pending this decision, it would be required by section 6(4) of the *Securities Rules* to join the MFDA. The MFDA's rules, which the commission has accepted, prohibit a member firm from lending to clients.

¶ 42 When staff first challenged CFC on its practice of lending to clients, before the MFDA was established, they resolved the issue by letting CFC set up CFSI and, in effect, lend the money indirectly. Staff later took the position that this change did not resolve their concerns and put a condition on CFC's and Connor's registrations to prevent CFSI from making new loans.

¶ 43 We agree that the combined effect of the commission's and MFDA's rules prohibits mutual fund dealers from lending to their clients and that the CFSI structure, which is simply a way for CFC to lend to its clients indirectly, should not be a way around the rule. However, we also note the MFDA's comment that, in applying its rule to a particular situation, one has to review all relevant facts and considerations to assess whether lending would be inappropriate in the circumstances. Although the MFDA says it has never exempted a member from rule 3.2.1, it has evidently not taken the position that the rule prohibits a member's affiliated financial institution from lending to the member's clients. We assume that the MFDA has assessed the "relevant facts and considerations" in reaching that position.

¶ 44 We have some sympathy for Connor's and CFC's argument that the loans provided were beneficial to clients because they were made on more flexible terms than the clients might otherwise have been able to get. Connor and CFC are in conflict of interest in making these loans, but this is just one of the many conflicts of interest that are inherent in the securities business. The appropriate question is whether Connor and CFC can manage this conflict in a way that protects the interests of the clients. The presumption of the MFDA rule is that they cannot and, therefore, that the practice of lending must be prohibited. Should CFC be exempted from this restriction and, if so, on what conditions?

¶ 45 Both parties in this review say that we should let the MFDA get on with reviewing an application for membership by CFC and, in doing that, decide whether to give an exemption from its rule to let CFC lend to its clients. We agree that we should leave that decision to the MFDA. Of course, its decision could be brought back to the commission on a review, but that review would be better informed by the MFDA's analysis.

¶ 46 The question for us is what to do in the meantime. Staff would have us maintain the prohibition on lending and direct an orderly wind up of the existing loans. Connor and CFC would have us remove the prohibition and let it resume lending unless and until the MFDA decides otherwise.

¶ 47 As staff argue, the current legislative policy clearly prohibits mutual fund dealers from lending to clients. We think the prudent course of action is to maintain the prohibition until the MFDA has an opportunity to consider and decide on CFC's application. However, we would also leave in place the arrangement for the existing loans. It seems premature to force a wind-up of the loan portfolio when the MFDA might decide to permit lending. The MFDA can deal with the existing portfolio when it decides on the broader application.

¶ 48 That leaves the question of whether CFC should be able to treat the receivable from CFSI as a current asset for its working capital calculation.

¶ 49 Section 70(3) of the securities rules requires a mutual fund dealer to file a report of working capital in the required form. The required form is BC Form 33-905F, *Report of working capital*, which says, "The calculation is intended to demonstrate an adequate level of available financial resources in conducting the day-to-day operations of the registrant's business. Please note that minimum working capital prescribed in the Securities Rules is intended as a crisis threshold and that registrants should plan to maintain amounts significantly in excess of this amount on a daily basis." Note 1 of the report of working capital says, "For the purposes of this calculation, any related party balances which are not generated in the "normal course" of the registrant's business (e.g., intercompany or shareholder loans receivable are not generated from the normal revenue stream) are not considered as allowable current assets and should be excluded."

¶ 50 CFC has a receivable from CFSI, which is equal to CFSI's loans to CFC's clients. Staff argue that this is a related party balance, because CFC and CFSI are both owned by Connor, and that it was not generated in the normal course of CFC's business, because CFC is a mutual fund dealer, not a lending institution. Staff therefore take the position that note 1 of Form 33-905F does not allow CFC to treat the CFSI receivable as a current asset. We think this is an unduly technical interpretation of the form.

¶ 51 CFC's receivable is from a related party, CFSI, rather than directly from CFC's clients, only because of staff's earlier intervention to force CFC to make the loans indirectly rather than directly. Also, at the time CFC made the loans, they were clearly part of its mutual fund dealer business. In our view, therefore, note 1 of the form does not apply to this receivable.

¶ 52 As Connor and CFC say, CFSI's loans to clients are payable on demand and are secured by client mutual fund securities. CFSI has pledged its loan receivables to CFC as security for its loan from CFC. The loan to CFSI would therefore seem to qualify as a current asset for CFC's working capital calculation.

¶ 53 Based on staff's interpretation that note 1 would prohibit the inclusion of the CFSI receivable as a current asset, McLennan gave a variation of the form requirements to permit CFC to include the receivable and Halischuk later withdrew that variation. Based on our interpretation, no variation was necessary and withdrawing it had no effect. CFC is free to include the receivable from CFSI as a current asset in its calculation of working capital as long as it is secured as described in the previous paragraph.

¶ 54 We hasten to note, however, that we received no submissions about how this receivable would be treated under the capital requirements in the MFDA rules. CFC should consider the MFDA requirements before making any changes to its capital.

Decision

¶ 55 Accordingly, we confirm the conditions on the registrations of Connor and CFC that prohibit further lending to CFC's clients, either directly or indirectly. These conditions will remain in effect until CFC becomes a member of the MFDA. We find the decision to withdraw the variation of the working capital calculation to be of no effect.

¶ 56 August 10, 2005

¶ 57 For the Commission

Douglas M. Hyndman
Chair

John Graf
Commissioner

Roy Wares
Commissioner